Alpha Opportunities in China and Hong Kong

SGA Alpha Factor Effectiveness in China and Hong Kong

Cynthia Tusan, CFA
Lead Portfolio Manager

Gary Baierl, PhD
Chief Investment Officer

Mark Wimer, CFA
Senior Portfolio Manager

Introduction

Strategic Global Advisors (SGA) has been investing client assets in international equities since the firm was founded in late 2005. While the majority of these assets have been invested in developed non-US markets, we have consistently included material allocations to emerging markets including China. Recently we examined potential reasons for the particular effectiveness of our proprietary Alpha model in evaluating companies in emerging markets. We examined trends in company specific data availability and sell-side analyst coverage in emerging markets, an area generally considered less efficient relative to developed markets.

In this paper, we focus on backtesting our model for both China and Hong Kong headquartered companies. In 1997, Hong Kong became a "Special Administrative Region of China" as part of a "one country, two systems" policy. While China based companies are generally considered emerging market companies while Hong Kong based companies are considered developed market stocks, the expected convergence of the two countries by 2047 means that analyzing them side by side could highlight potential trends.

A companion "Country Spotlight" report provides some more detail on the comparative analysis of the markets, currencies, and economies of China and Hong Kong. For the purposes of this report, we focus only on the Hong Kong stock exchange which serves as the gateway for foreign investors to trade both Chinese (referred to as H shares) and Hong Kong companies (referred to as Hong Kong ords). This analysis looks at the data for these two segments both together and separately.

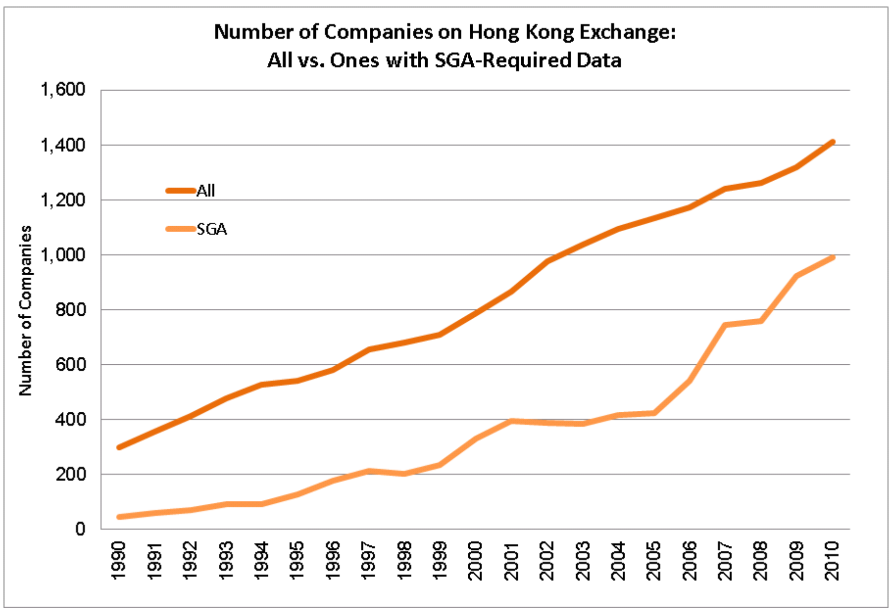
Number of Companies in Universe

The Hong Kong exchange was launched in 1891 and, since then, has made Hong Kong based companies available to investors for investment continuously.

Despite China's large size, Chinese stock markets, both the Shanghai exchange and Shenzhen exchange which opened in 1990, are largely closed to foreign investors. In 1993, Chinese companies began listing their companies on the Hong Kong exchange. The only Chinese companies that investors can generally access are those that list their stocks on the Hong Kong exchange as H shares. Many of these H shares are simultaneously available on the US exchanges as ADR's.

Previous SGA research has highlighted that analyst coverage has increased slowly over time. This is in part due to the lack of comprehensivie data readily available. The darker orange line in the chart below illustrates the growth in the number of companies listed on the Hong Kong exchange, while the lighter orange line highlights the number of companies with sufficient data for calculating an SGA Alpha. As of the end of 2010, there were over 1,400 companies listed on the Hong Kong Exchange and 1,000 of those had an SGA Alpha.

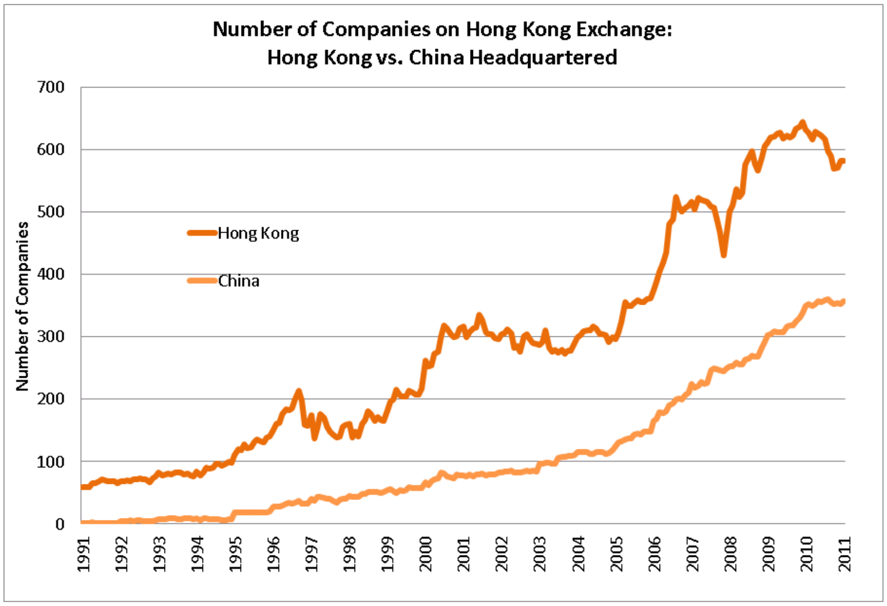
The number of companies where we can calculate an SGA Alpha has increased dramatically over time but is still limited by the data



Sources: World Federation of Exchanges, SGA Analytics, FactSet

When we break out the Chinese and Hong Kong companies in the SGA calculation univserse, we see that there are significantly more Hong Kong companies that list, but by 2011 there are a large number of companies representing both regions.

When conducting a comparative backtest of Hong Kong based companies and China based companies the analysis must start later due to the limited number of Chinese companies.

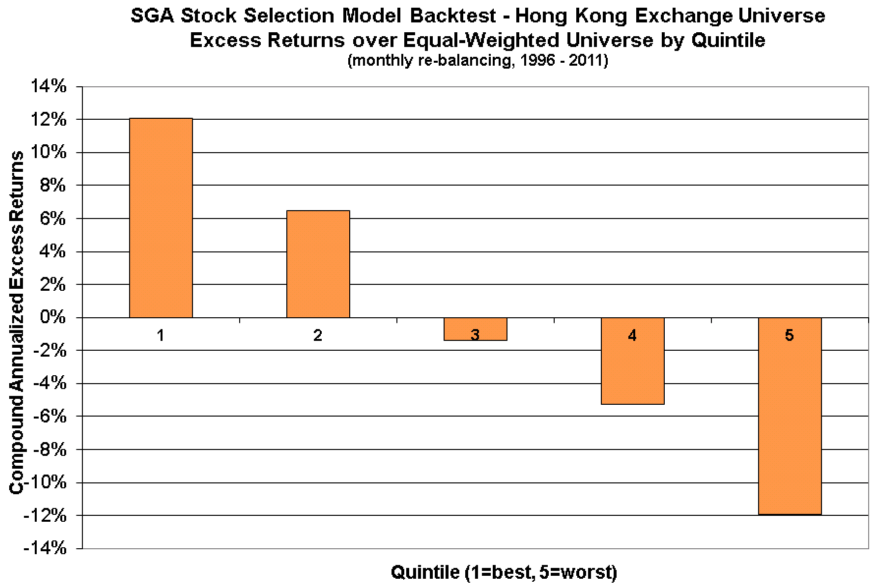


Sources: SGA Analytics, FactSet

SGA Alpha Model and Company Coverage

SGA uses a quantitative stock selection (or Alpha) model as part of our investment process. This model produces an expected relative return for equities within the global investment universe. Stocks are ranked relative to their global industry peers across all countries in both developed and emerging markets. In backtests, live model performance, and live portfolios the Alpha model has been shown to work well globally but is generally even more effective in less efficient areas of the world such as emerging markets.

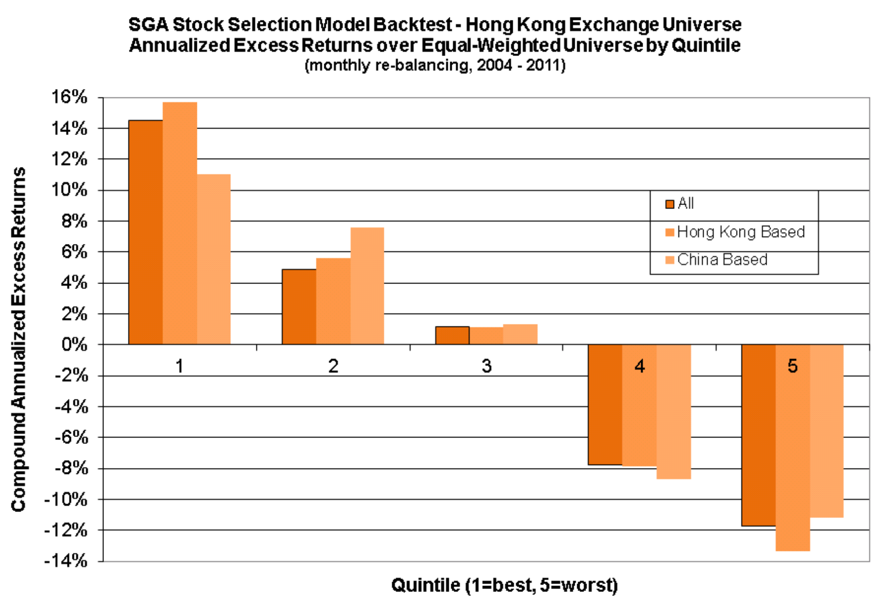
We begin the analysis by testing the factors for the combined universe. This allows us to test back to 1996, where the availability of Hong Kong stocks makes up for the low number of Chinese stocks. The stock are ranked monthly and divided into quintiles. Portfolios are created based on these quintiles effectively simulating a monthly rebalance, based solely on the company ranks. The chart below provides the returns in excess of an equal weighted universe. Each bar represents a quintile, the first being the highest, or best rated companies and 5 representing the lowest or worst rated companies. We see that the highest rated companies do in fact produce the greatest excess returns, and fall monotinically with each quintile.



Sources: SGA Analytics, FactSet

Next we separate the Hong Kong and Chinese companies to examine whether the SGA model produces meaningful results in both segments. Due to the lack of China based stocks, we begin the analysis in 2004.

The model is even more effective in Hong Kong stocks.



In both cases, the average annualized excess return is shown relative to the equal-weighted universe for each quintile, where “1” is the top ranked group and “5” is the bottom ranked group. The Alpha model has, on average, shown an ability to identify which stocks subsequently outperform and underperform, both for Hong Kong and China based companies. This gives us confidence that the underlying "engine" of our investment process is effective and has good raw predictive power. What is also apparent is the model is even more effective in Hong Kong based companies. In this analysis, the assumed benefit of "emerging markets" excess returns over developed markets does not hold.

Conclusion

In previous papers, the SGA Alpha was shown to be effective globally especially in less efficient areas such as emerging markets. This paper specifically looks at stocks that trade on the Hong Kong exchange where we find a mix of developed and emerging market stocks. Hong Kong based companies are considered developed market stocks while Chinese based companies are considered emerging market stocks. When applied to these stocks as a whole, the model performs well and when applied separately to Hong Kong stocks and and then to China stocks, we find that the model provides superior results for the developed market stocks, namely the Hong Kong based companies. Given that this separate, comparative analysis could only be done for the shorter period, which covers a significant transition for Hong Kong, we would not necessarily draw a conclusion that the model will continue to perform significantly better in Hong Kong than in China. Future trends will be monitored as these markets grow and evolve over time.

STRATEGIC
GLOBAL
ADVISORS, LLC

Important Disclosures

SGA Alpha Model Backtest on Pages 4 & 5:

- Time period January 1996 to December 2011 and January 2006 to December 2011
- Formed equal weighted quintiles based on SGA Alphas
- Monthly rebalancing with no transaction costs
- Included: Companies traded on the Hong Kong Exchange

Source: FactSet and Strategic Global Advisors

Past performance is not indicative of future results. Returns are presented gross of fees.

This is supplemental information to the Annual Disclosure Presentation.

There are limitations inherent in backtested model results, particularly the fact that such results do not represent actual trading and that they may not reflect the impact that material economic and market factors might have had on portfolio decision-making in a live client account. SGA did not manage any live large cap accounts during the entire backtest period. The results portrayed reflect the reinvestment of dividends and other earnings. International equity investing includes the possibility of loss. Equal-weighted quintile returns by SGA Alpha are compared to the equal-weighted small cap universe.

The volatility of the index may be materially different from that of all quintile returns by SGA Alpha.